

**DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS 99-0055
STATE GROSS RETAIL AND USE TAXES
For Years 1994, 1995, 1996, and 1997**

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ISSUES

- I. State Gross Retail Tax – Equipment Used in Retail Stores:** In-store equipment used in the preparation of consumer paint products.

Authority: IC 6-2.5-2-1; IC 6-2.5-5-3(b); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(g); 45 IAC 2.2-5-12(a).

Taxpayer seeks clarification of the determination, set out within the original Letter of Findings, that certain of the taxpayer's in-store equipment, subject to certain limitations, was exempt from the imposition of the Indiana gross retail tax.

- II. Applicability of the State's Gross Retail Tax to Items of Manufacturing Equipment.**

Authority: IC 6-2.5-2-1; IC 6-2.5-5-3(b); 45 IAC 2.2-5-8; 45 IAC 2.2-5-8(a); 45 IAC 2.2-5-8(b); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(c)(2); 45 IAC 2.2-5-8(c)(2)(A); 45 IAC 2.2-5-8(c)(2)(G); 45 IAC 2.2-5-8(c)(3); 45 IAC 2.2-5-8(c)(3)(A); 45 IAC 2.2-5-8(d); 45 IAC 2.2-5-8(g); 45 IAC 2.2-5-8(i).

Taxpayer claims that certain items of equipment, not addressed within the original Letter of Findings, are exempt from the state's gross retail tax.

STATEMENT OF FACTS

Taxpayer is an Ohio Corporation headquartered in Ohio and authorized to do business in Indiana. Taxpayer is a manufacturer, wholesaler, and retailer of paint, powder coatings, and related products. Taxpayer operates approximately 30 primary manufacturing facilities located throughout the United States including a powder coatings manufacturing facility located in Indiana. During the tax years 1994 and 1995, taxpayer operated a warehouse in Indiana in which paint and paint related products were stored for shipment

to locations within and outside of Indiana. Subsequent to the issuance of the original Letter of Findings, taxpayer requested an opportunity for a rehearing. In that request, the taxpayer argued that tax issues related to the purchase of certain items of equipment were not addressed within the Letter of Findings. Taxpayer has also sought clarification of language addressing the taxability of items of equipment purchased by taxpayer for use in its retail outlets. This Supplemental Letter of Findings revisits those issues.

I. State Gross Retail Tax – Equipment Used in Retail Stores.

DISCUSSION

Pursuant to IC 6-2.5-2-1, a sales tax, known as the state gross retail tax is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Under IC 6-2.5-5-3(b), 45 IAC 2.2-5-12(a), an exemption from the state's gross retail tax is provided for transactions involving the purchase of manufacturing machinery, tools, and equipment if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. 45 IAC 2.2-5-8(c) defines "direct use" as use having an immediate effect on the article being produced. Property has such an immediate effect if the property "is an essential and integral part of an integrated process which produces tangible personal property." 45 IAC 2.2-5-8(g).

Taxpayer produces a white base paint at its primary production facility. This white base paint is then shipped to taxpayer's various retail outlets. Not all the white base is identical because different colors require the use of different bases having different chemical qualities. The "gallon" containers of white base actually contain less than a full 128 fluid ounces in order to permit the eventual addition of colorants.

Taxpayer's retail customers may choose paint in one of two ways. The customer may select a paint color from one of the taxpayer's color cards. Alternatively, customer may bring in a color sample to be custom-matched. Once the customer selects or provides the desired color, taxpayer's employee begins a process by which the specified paint is produced. If the customer has brought in a color sample, that sample is measured by the Color Matching System (a spectrophotometer or other color-sensing device). The resulting measurements are converted to a numerical value, which is sent to the taxpayer's computer equipment. The computer equipment in turn produces a unique color formula which is sent to an Automatic Colorant Dispenser.

If the customer chooses a standard color from a color card, taxpayer's employee enters a color identification number into the computer which is transferred to the Automatic Colorant Dispenser.

The Automatic Colorant Dispenser meters out the appropriate amount of individual colorants required to produce the customer's finished paint product. An attached printer

produces a label, listing the color identification number and colorant ingredients, which is attached to each container of finished product.

Once colorant has been added to each paint container, the containers are placed into a Shaker and the paint is properly mixed. If this last step is not completed, customers would not obtain a useable product because the colorants would not be evenly dispersed throughout the can of paint. It is not possible for customer to mix their own paint by taking the paint home and stirring it themselves, because customers would not be able to satisfactorily disperse the colorant.

Taxpayer originally argued that its purchase of four items of equipment, installed at its retail outlets, came within the ambit of IC 6-2.5-5-3(b), because the equipment was purportedly directly used “in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.” Id. The four items of equipment addressed within the original Letter of Findings included: 1) Color Matching Systems, 2) Automatic Colorant Dispensers, 3) Related Computer Equipment, and 4) Shakers.

Subject to certain limitations set out in the original Letter of Findings, it was determined that taxpayer’s purchase of Shakers was exempt from the imposition of sales tax pursuant to IC 6-2.5-5-3(b). Neither that original determination nor the associated limitations are at issue here. Instead the taxpayer has requested that the language setting out that determination be clarified. The remaining three items of equipment are irrelevant to this Supplemental Letter of Findings.

The language contained within the original Letter of Findings stated that “[t]o the extent that taxpayer’s Shakers are used to mix customized paint products, the Shakers are exempt from the gross retail tax under IC 6-2.5-5-3(b). However, to the extent the Shakers are used to mix the taxpayer’s non-customized paints, the Shakers are not entitled to the exemption. In addition, to the extent that the Shakers are used to re-mix paints previously sold but which may have over time become separated, the Shakers are also not entitled to the exemption.”

The meaning, intent, and effect of the quoted language was to determine that taxpayer’s purchase of the Shakers was not subject to the state’s gross retail tax to the extent that the Shakers were used to mix certain, defined paint products as follows;

1. The purchase of the paint Shakers was exempt from the state’s gross retail tax to the extent the Shakers were used to mix customized paint products for which the customer brought in a color sample and for which taxpayer created and executed a unique color formulation.
2. The purchase of the paint Shakers was exempt from the state’s gross retail tax to the extent the Shakers were used to mix paint products which were formulated in accordance with a customer’s selection from one the taxpayer’s own standardized color cards.

3. The purchase of the paint Shakers was not exempt from the state's gross retail tax to the extent that the Shakers were used to re-mix paint products, previously sold to a customer, but which, over time, had become separated.
4. The purchase of the paint Shakers was not exempt from the state's gross retail tax to the extent that the paint Shakers were used to mix off-the-shelf paints in which colorants had previously been added and which were not modified by the retailer to conform to the customer's requirements or specifications.

II. Applicability of the State's Gross Retail Tax to Items of Manufacturing Equipment.

DISCUSSION

In its request for a rehearing, taxpayer has requested that the Department address the taxability of items of equipment not adequately addressed within the original Letter of Findings. The taxpayer has requested that the taxability of the following items of equipment be addressed: wet dry vacuums (00017, 00018, 00019); sieve shaker (00023); convection ovens (00077, 00078), model and cup spray guns (00027, 00028); air compressor (00042); analytical balance scales and gram scales (00046, 00062, 00063, 00064); color eye system (00071); vacuum (00080); conveyor belt (00088). The original audit reference numbers are included to identify specifically the various items of equipment at issue.

Pursuant to IC 6-2.5-2-1, a sales tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. IC 6-2.5-5-3(b) provides that "[t]ransactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property." 45 IAC 2.2-5-8(c) defines "direct use" as that use having an immediate effect on the article being produced. Property has such an immediate effect if it is an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-8(c).

A brief description of the taxpayer's production process is warranted. Raw materials are measured, mixed, heated, and transformed into a liquid state within a device called an extruder. As the liquid is discharged from the extruder, it passes through cooling rolls which transform the product into a solid form. This solid material is transported by means of a conveyor to a crusher. The crusher is the first step in reducing the solid to its final, saleable form. The crushed material is transported to a grinding mill, which completes the transformation of the paint product to a uniformly fine powder. Attached to the grinding mill are various devices – including a sifter - which remove non-conforming particles and dust. At various times during production, powder coating samples are removed and subjected to quality control testing.

A. Wet Dry Vacuums.

Taxpayer argues that its purchase of three Wet Dry Vacuum cleaners should not be subject to the state's gross retail tax. These vacuum cleaners are portable units used within the taxpayer's powder coatings plant. The Wet Dry Vacuums are used to clean the taxpayer's production equipment in order to assure that unwanted particles, remaining after the production of one batch of powder coating, are removed and do not contaminate the next batch.

The Wet Dry Vacuums do not fall within the manufacturing exemption and are, therefore subject to imposition of the state's gross retail tax. Although necessary to the production of uncontaminated powder coatings, the Wet Dry Vacuums are properly categorized as outside and independent of the taxpayer's actual production of powder coatings. In order to come within the manufacturing exemption, the equipment must be "directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property." 45 IAC 2.2-5-8(c). The Wet Dry Vacuums are not involved in the "direct production" of taxpayer's production process because "[d]irect use in the production process' begins at the point of the first operation or activity constituting part of the integrated production process and *ends at the point that the production has altered the item to its completed form . . .*" 45 IAC 2.2-5-8(d) (Emphasis added).

B. Sieve Shaker.

Taxpayer argues that the purchase of its Sieve Shaker is exempt from the imposition of the state's gross retail tax under 45 IAC 2.2-5-8 because the equipment is part of the taxpayer's integrated manufacturing process. During the production of powder coatings, the sieve shaker sifts through the powder coatings after the coatings have been processed through the grinding mill. The Sieve Shaker operates to detect and remove those particles which have not obtained a specified consistency. Absent the operation of the Sieve Shaker, taxpayer's customers would not receive a product which conforms to the customer's specifications or needs.

Taxpayer's Sieve Shaker is exempt from the imposition of state's gross retail tax because the Sieve shaker has "an immediate effect on the article being produced." 45 IAC 2.2-5-8(c). The device acts directly upon the taxpayer's powder coatings in such a way as to remove those particles which would otherwise render the final product unsatisfactory. The device is an "integral part of an integrated process which produces tangible personal property." 45 IAC 2.2-5-8(c).

C. Convection Ovens.

Taxpayer maintains that the purchase of two Convection Ovens is exempt from sales tax because the ovens are purportedly testing equipment, which qualify for the manufacturing exemption. During the taxpayer's production of powder coatings, samples of the coatings are removed at pre-determined times and subjected to certain testing procedures to assure that the coatings conform to taxpayer's and customer's specifications. The Convection Ovens are used to bake panels upon which powder coatings have been applied. Once the panels have been baked, they are examined to determine if the finished coating meets thickness, gloss, color, and adhesion specifications. This testing process is intended to assure that the powder coatings then being produced within taxpayer's manufacturing process – once actually applied to one of the test bake panels – meet the specifications established by taxpayer and taxpayer's customer. If the testing process reveals that the powder coatings then being manufactured do not conform to the required specifications, the manufacturing process is halted and the powder coatings produced to that point are discarded. The manufacturing process is restarted only after the necessary adjustments have been made.

Taxpayer predicates its exemption claim on 45 IAC 2.2-5-8(i) which states that, “[m]achinery, tools, and equipment used to test and inspect the product as part of the production process are exempt.” The regulation offers an example in which the testing equipment is exempt. The example provides a scenario in which;

“[s]elected parts are removed from production according to a schedule dictated by statistical sampling methods. Quality control equipment is used to test the parts in a room in the plant separate from the production. Because of the functional interrelationship between the testing equipment and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated production process and is exempt.”

Accordingly, to the extent that the Convection Ovens are employed to test the quality of taxpayer's powder coatings “as part of the [taxpayer's] production process” (45 IAC 2.2-5-8(i)), the convection ovens are exempt from imposition of the gross retail tax. However, to the extent that the same Convection Ovens are used to test taxpayer's product subsequent or prior to the actual manufacturing process, the Convection Ovens are subject to sales tax because “off-line” testing no longer exhibits the “functional interrelationship between the testing equipment and the machinery on the production line” justifying the exemption. Id.

D. Model and Cup Spray Guns.

Taxpayer argues that the purchase of the Spray Guns is exempt from sales taxes for the same reasons set forth in the discussion concerning the Convection Ovens. The Spray Guns are used to spray powder coatings on test panels during the taxpayer's testing process.

As with taxpayer's Convection Ovens, taxpayer's Spray Guns qualify for the gross retail tax exemption under 45 IAC 2.2-5-8(i) to the extent the Spray Guns are used to test taxpayer's products "as part of the [taxpayer's] production process." Conversely, the Spray Guns do not qualify for the exemption to the extent the Spray Guns are used for testing prior and subsequent to the actual manufacturing process.

E. Color Eye System.

Taxpayer maintains that its purchase of a Color Eye System is exempt from the sales tax under 45 IAC 2.2-5-8(i). The Color Eye System is a device capable of precisely measuring the color qualities of taxpayer's powder coatings. During the production of those coatings, samples of the powder coatings are removed from the production line and subjected to quality control testing. The coatings are applied to sample panels. The panels are then subjected to various tests including a test, conducted by means of the Color Eye System, to assure that the taxpayer's finished product will meet taxpayer's and customer's color specifications.

Similar to the finding concerning taxpayer's Convection Ovens and Model and Cup Spray Guns, taxpayer's Color Eye System – to the extent the system is employed to test taxpayer's powder coatings "as part of the [taxpayer's] production process" – is exempt from imposition of the gross retail tax under the provisions of 45 IAC 2.2-5-8(i). However, to the extent the Color Eye System is used to conduct product testing outside the taxpayer's actual production process, the Color Eye System remains subject to sales tax.

F. Air Compressor.

Taxpayer argues that the purchase of its Air Compressor is exempt from the state's gross retail tax because it is an item of equipment having a direct and immediate effect on the taxpayer product. The Air Compressor is used to supply compressed air – acting as a power source – to certain items of manufacturing equipment. The purchase of the air compressor is entitled to the exemption. The most closely analogous regulatory example is found at 45 IAC 2.2-5-8(c)(2)(A) which states that "[a]ir compressors used as a power source for exempt tools and machinery in the production process" are part of the integrated production process and are, therefore, exempt. "The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative." 45 IAC 2.2-5-8(c)(2).

G. Analytical Balance Scale / Gram Scale.

Taxpayer argues that its purchases of Analytical Balance and Gram Scales are exempt from the state's gross retail tax because the scales are a part of the taxpayer's manufacturing process. The scales are used to measure minute amounts of raw materials

– including pigments and resins – which are then combined with other raw materials at the inception of the powder coatings manufacturing process. The scales are exempt because the scales are a part of the integrated process of producing powder coatings in which the scales are used to weigh and measure the powder coatings constituent ingredients. The most closely analogous example is found at 45 IAC 2.2-5-8(c)(2)(G) which states that an “automated scale process” employed to measure quantities of raw aluminum used in the next production step is exempt.

H. Vacuum.

Taxpayer argues that the purchase of this Vacuum device should be exempt from the state sales tax because it is a constituent part of the taxpayer’s integrated manufacturing process. The vacuum is connected to hoses which are, in turn, attached to the powder coatings production line. The Vacuum device is attached to the taxpayer’s production lines and used to clean the production line of materials remaining after the production of a batch of powder coatings. These materials must be removed to assure that the next batch of powder coatings will not be affected or contaminated.

Although taxpayer intimates that the Vacuum device is capable of being employed during the production process, the device is primarily used as a pre-production or post-production item of equipment. As such, it does not qualify for a sales tax exemption under 45 IAC 2.2-5-8(b). As set out in 45 IAC 2.2-5-8(d), “‘Direct use in the production process’ begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form” The Vacuum device stands one step removed from taxpayer’s production of powder coatings making its purchase price subject to the state’s gross retail tax.

I. Conveyor Belt.

Taxpayer argues that its purchase of a conveyor belt should be exempt from the state’s gross retail tax because the conveyor belt is part of the taxpayer’s manufacturing process. The conveyor belt is located between the cooling rolls and the crusher. The conveyor belt transports the solidified powder coatings material between intermediary steps of the taxpayer’s production process and is entitled to the manufacturing exemption under 45 IAC 2.2-5-8(a). The conveyor belt is an item of manufacturing equipment directly used by the taxpayer to produce finished tangible personal property. 45 IAC 2.2-5-8(b). The conveyor belt has an immediate effect on the taxpayer’s powder coatings because it is “an essential and integral part of an integrated process which produces tangible personal property.” 45 IAC 2.2-5-8(c).

In summary, taxpayer’s wet dry vacuums (00017, 00018, 00019) and vacuum (00080) are not entitled to an exemption from the state’s gross retail tax. Taxpayer’s convection ovens (00077, 00078), model and cup spray guns (00027, 00028), color eye system

(00071) sieve shaker (00023), air compressor (00042), analytical balance scales and gram scales (00046, 00062, 00063, 00064), and conveyor belt (00088), subject to the limitations contained within this Supplemental Letter of Findings, are exempt from the gross retail tax.

FINDINGS

Taxpayer's protest is denied in part and sustained in part.

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